DEFENSE CONTRACT AUDIT AGENCY
DEPARTMENT OF DEFENSE
8725 JOHN J. KINGMAN ROAD, SUITE 2135
FORT BELVOIR, VA 22060-6219

OFFICE OF THE DIRECTOR

November 25, 2002

Lawrence P. Farrell, Jr.
President and CEO
National Defense Industrial Association
2111 Wilson Boulevard, Suite 400
Arlington, VA 22201

Dear Mr. Farrell:

The Defense Contract Audit Agency (DCAA) appreciates your interest in addressing the problem of delinquent contractor incurred cost submissions. The audit guidance on developing unilateral recommendations that we issued in June 2002 was the result of many months of collaborative discussions with the Defense Contract Management Agency (DCMA) and other members of the Department of Defense community. Many of the points raised in your letter were raised in our deliberations as well, and were considered in developing our guidance.

DCAA closely follows governmental auditing standards and needs to be independent in mental attitude with respect to the formulation of our audit plans and approaches as we satisfy our customers' auditing and financial advisory services needs. While litigative risk can always be present in any business arrangement, it should not influence the exercise of the auditor's judgment in planning and performing the audit. Regardless of this, we do not believe that the risk of litigation is high since the logical remedy for a contractor who disputes the unilateral determination that a contracting officer makes in accordance with FAR 42.703(c)(2) is to simply comply with FAR 52.216-7 and submit its certified indirect cost rate proposal.

The objective of our guidance is to assist our customers, the contracting officers (COs), in carrying out their contract administrative responsibilities in instances where contractors are in noncompliance with FAR 42.703-2(c)(2). Our recommendation to the CO to use either a contractor-specific historical disallowance factor or the 20 percent overall Agency decrement factor is in accordance with FAR 42.703-2(c)(2)(ii) which prescribes what actions the CO should take when contractors fail to comply with regulations. As the Department's financial advisor to the CO, it is encumbent upon us to provide recommendations based upon the best available data that protect the Government's interest in these circumstances. The 20 percent decrement factor is based on DCAA-wide questioned costs (both direct and indirect) for high risk contractors, and was calculated on a base of total contract costs. This factor can be readily applied by the CO on a total contract cost basis should the decision be made to pursue that avenue for closing contracts of noncompliant contractors. A factor based only on indirect costs would have been much higher, and more difficult to apply. We do not consider it appropriate to recommend a factor based upon sustained cost questioned in these circumstances since it would represent the result of CO/contractor negotiation activities and related events which occur subsequent to DCAA's audit and reporting activities.

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Contrary to the concern and premise raised in your letter, the size mix of high risk contractors that we used to calculate the 20 percent decrement factor is comparable to the mix of contractors that are delinquent in submitting their certified indirect cost rate proposals. Of the contractors used to calculate the 20 percent decrement factor, 84% and 88% for fiscal years 2000 and 2001, respectively, are contractors with less than $10 million of auditable at-risk direct and indirect costs. In our November 2001 analysis of 948 submissions more than six months delinquent, approximately 80 percent were contractor years with less than $10 million dollars. In our October 2002 analysis of delinquent submissions, 76 percent were contractor years with less than $10 million dollars.

Providing an adequate, appropriately certified incurred cost rate proposal is a contractual requirement for the contractor. We appreciate your acknowledgement that a company's ignorance or lack of sophistication is not an acceptable rationale for noncompliance with acquisition regulations or their contractual requirements. Unilateral recommendations are not made until exhaustive efforts are made by the local auditor and CO to remind the contractor of their contractual responsibilities and the potential consequences of their noncompliance with the Federal regulations. While we are not obligated to do so, we believe it is in the Department's best interest to be proactive and fully communicative in ensuring all contractors are aware of the submission requirements. Our field audit offices painstakingly track contractor submission due dates and send the contractor a letter three months after the close of their fiscal year reminding them of their contractual responsibility to submit an adequate indirect cost rate proposal. This letter informs the contractor that helpful information on preparing an incurred cost submission is available at the DCAA public web site in DCAA Pamphlet 7641.90, Information for Contractors, and the Incurred Cost Electronic (ICE) software.

A second reminder letter is issued 30 days after the contractor's submission is contractually overdue. Three months later, a memorandum is issued to the CO with a copy provided to the contractor which requests the CO's assistance in obtaining the delinquent submission. Two months later, when the submission is five months overdue, a final letter is sent to the contractor notifying them that the submission is past due, and advising that we will recommend that the CO exercise his/her authority to establish unilateral rates unless a submission is received or an extension is provided by the CO. It is only after these four notifications that a recommendation is made to the CO to establish unilateral indirect cost rates or total contract costs on contracts. Nevertheless, in order to give the widest dissemination possible to our policies, we agree with your suggestion to include additional coverage in our "Information for Contractors" Pamphlet that explains our guidance with respect to nonreceipt of adequate incurred cost rate proposals.

Making a final unilateral determination is a contracting officer's responsibility, and the CO has full authority to consider all factors including the DCAA recommendation in arriving at that determination. DCMA requested that the unilateral recommendations not be provided to the contractor because there may be circumstances where the CO has other information that would

result in an adjustment to the DCAA recommendation. When the CO makes the unilateral determination, the contractor will be informed of the basis used to arrive at the final rates or contract costs. The audit guidance on unilateral recommendations does not conflict with our audit manual in this regard. Your referenced DCAA Audit Manual section, 4-304.4, refers to exit conferences when an audit has been performed and there are audit results to discuss with the contractor. Our guidance on unilateral recommendations relates to situations when we have not received a submission and no audit work has been performed. Therefore, there is no basis (e.g. a contractor submission) to contrast and compare with DCAA audit results.

Our guidance on unilateral determinations is the latest in a series of instructions we have provided to auditors to improve the timeliness and receipt of contractor submissions. Since we issued our original guidance on obtaining overdue submissions in February 2001, the number of total delinquent submissions has dropped dramatically. There were 2,651 overdue submissions in January 2001 prior to issuance of the guidance. This number was reduced by 36% to 1,683 as of September 2002. Submitting a certified incurred cost rate proposal is a contractual and regulatory requirement for contractors. The process that we have implemented, in conjunction with DCMA, provides ample notification and offers of assistance to contractors prior to recommending a unilateral determination.

Finally, I suggest it would be helpful if you ascertain from your membership which companies have been the recipient of a unilateral determination of final rates. Understanding their rationale for not providing the required submission would be of interest to us prior to any attempts to revisit our guidance with respect to this issue. If you have some specific suggestions based on specific case data and illustrations, we would be glad to consider them.

Sincerely,

William H. Reed
Director

Copy furnished:
Hon. Michael Wynne, DUSD (AT&L)
Deidre A. Lee, DDP
BG Edward Harrington, DCMA